

## September 2008

### Australian economy

For the first half of 2008, the Australian economy grew at an annualised rate of 2.3%, down from 3.7% in the second half of 2007. Very soft, given that the potential rate of growth of the Australian economy is around 3.75%. The RBA moved to cut rates by 25 basis points in response to slower growth with the cash rate currently at 7.25%.

Most of the slowdown was concentrated in the household sector with household consumption having its first fall since the September quarter of 1993. On the positive side business investment and exports volumes rose over the quarter.

After the June quarter National Accounts, nab Capital (NAB) adjusted their forecasts and now expect GDP to grow by only 2.5% in 2008, down from 2.75% previously. For 2009, their forecast is unchanged at 2.25%.

### Australian shares

Australian shares stabilised in August in anticipation of RBA rate cuts. Forward P/E ratio on the ASX 200 are at 11-12, compared to an historic average of around 15-16, suggesting some value has already been created in our market.

### Global economy

Global economies are still struggling, with China, Japan and Europe all showing signs of further weakening. US GDP is estimated to have grown at an annualised rate of 3.3% in the second quarter but this is expected to fall again in the quarter ahead.

There are real concerns that the Japanese and Eurozone economies could fall into recession while the pace of growth in China is slowing.

### International shares

Emerging markets have had large falls, with China down 13.6% in the month and 54% over the past year. Overall global markets were down which is consistent with a re-rating of expected corporate profit growth ahead and ongoing financial de-leveraging.

### Oil

Over the past month the price of oil has been in a downtrend. Having peaked at a high of \$147.27/bbl on 11 July, the oil price has since moved lower.

Rising inventories in the US, speculators/investors dumping their futures positions and a stronger US dollar have all helped to drive the oil price lower.

### August market performance

Equity Markets – Price Indices		At Close 31/8/08	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	5215.47	3.2%	-16.5%
Japan	Nikkei	13072.87	-2.3%	-21.1%
Hong Kong	Hang Seng	21261.89	-6.5%	-11.4%
UK	FTSE 100	5636.60	4.2%	-10.6%
Germany	DAX	6422.30	-0.9%	-15.9%
US	Dow Jones	11543.55	1.5%	-13.6%
EMU*	Euro 100	2515.39	0.9%	-21.2%
World**	MSCI – Ex Aus	862.58	-9.9%	-24.3%

Property – Price Index		At Close 31/8/2008	% Change 1 Month	% Change 12 Months
Listed Trusts	ASX LPT	1459.20	8.9%	-39.6%

Interest Rates		At Close 31/8/2008	Point Change	
			1 Month	12 Months
Aust 90 day Bank Bills		7.25	-0.49	0.38
Australian 10 year Bonds		5.74	-0.49	-0.17
US 90 day T Bill		1.72	0.05	-3.44
US 10 year Bonds		3.82	-0.13	-0.71

Currency		At Close 31/8/2008	% Change 1 Month	% Change 12 Months
US dollar	A\$/US\$	0.8580	-8.9%	4.8%
British pound	A\$/STG	0.4709	-0.8%	16.0%
Euro***	A\$/euro	0.5845	-3.2%	-2.7%
Japanese yen	A\$/yen	93.37	-8.1%	-1.5%
Trade-weighted Index		67.80	-6.1%	2.4%

\* Top 100 European stocks trading on the FTSE

\*\* Source : www.msci.com

\*\*\* The euro was launched by European Monetary Union members on 1/1/99.

Source : Iress Market Technology

Past performance is not a reliable indicator of future performance.

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## Australian economy and markets

The essentials:

- For the first half of 2008, the economy grew at an annualised rate of 2.3%, down from 3.7% in the second half of 2007. Very soft, given that the potential rate of growth of the Australian economy is around 3.75%.
- The RBA made their first rate cut in almost seven years, bringing the cash rate down to 7.25%.
- The AUD was pummelled through August and early September, initially driven lower by the abrupt reversal in RBA interest rate expectations.
- Australian shares stabilised in August in anticipation of RBA rate cuts. The ASX 200 was up 3.2% in the month, but still down 18% for the year.
- Over the past month the price of oil has been in a downtrend. Having peaked at a high of \$147.27 on 11 July, the oil price has since moved lower.

### The economy at a glance

For the first half of 2008, the economy grew at an annualised rate of 2.3%, down from 3.7% in the second half of 2007. Very soft, given that the potential rate of growth of the Australian economy is around 3.75%.

Most of the slowdown was concentrated in the household sector. Household consumption actually fell in the June quarter making a negative contribution to growth in the quarter. This is the first fall in household consumption since the September quarter of 1993, which came in the wake of the 1990 - 1991 recessions, while the unemployment rate was still hovering above 10%.

Data on production by industry provides further evidence that households are bearing the brunt of the economic downturn. This showed the retail sector, accommodation, cafes & restaurants, electricity gas & water, agriculture, finance & insurance all went backwards in the June quarter. Counteracting the weakness of the household sector in the National Accounts was strong growth in business investment and exports.

Business investment rose by a strong 4.6% in the June quarter, up by 10.8% over the year to June 2008.

Export volumes rose by 2.7% in last quarter, contributing 0.6% to the quarterly growth rate.

Looking ahead NAB expects the economy to weaken over the next quarter, with household demand being a key driver.

NAB's model for household consumption is based on real disposable income, house prices, equity prices and petrol. With rising unemployment, household income growth will soften. Asset prices could remain at subdued levels for the next year as is expected that the AUD will decline against the USD and petrol prices will not drop significantly.

After the June quarter National Accounts NAB adjusted their forecasts. GDP is now expected to grow by only 2.5% in 2008, which was a 25 basis point reduction from 2.75%. NAB forecast for GDP growth in 2009 remains unchanged at 2.25%.

### Australian shares

Australian shares stabilised in August in anticipation of RBA rate cuts. The ASX 200 was up 3.2% in the month, but still down 18% for the year.

With the forward P/E ratio on the ASX 200 at 11-12, compared to an historic average of around 15-16, some value has already been created in our market. But with downside risks to macroeconomic and company profit growth persisting, investors will need a good comfort margin. NAB believes that sharemarkets will bottom around Quarter 4 2008 to Quarter 1 2009, which should be ahead of the low point in global economic growth.

### Australian dollar

The AUD was pummelled through August and early September, initially driven lower by the abrupt reversal in RBA interest rate expectations and then by sharp falls in commodity prices as global growth expectations were marked down. Some investor risk-aversion and unwinding in carry trades completed the rout. AUD/USD fell to 0.8102 on September 3, its lowest since August 2007, having started August above 0.9400. The AUD was the worst performing currency in the G10, its trade-weighted value falling 10% since the end of July.

The RBA cutting interest rates on September 2 for the first time in nearly seven years confirmed the start of an easing cycle that may not end until April next year with the cash rate down a cumulative 125 basis points. A 6% official cash rate is consistent with AUD/USD bottoming between 0.7500 and 0.8000.

### Interest Rates

The RBA made their first rate cut in almost seven years this month. With this cut, the RBA confirmed that the often stop/start rise in swap rates and bond yields over the past 6 years is over. Markets reached this conclusion a few months ago and have already rallied yields.

Two key factors will determine how far yields can fall here. First, how far will the RBA cut rates? Second, how much are markets already anticipating RBA cuts?

NAB Economists anticipate approximately 125 basis points of RBA cuts for this cycle, with one more 25 basis point cut in October and then three cuts in early 2009. This would set the official cash rate at 6%. As long as the credit/liquidity crunch doesn't intensify, this could see the 3 month (90 day) bank bill rate back towards 6.2-6.3% by mid 2009. **This may be a point of consideration given the increased popularity in bank bills.**

### Credit Markets

Domestically new issuance was slightly better than the previous month, although secondary market flows were still very light. Domestic issuance was once again limited to the banks and totalled \$3.6bn for August. This was up from the \$1.4bn issued in July, but just over half the average monthly volume (\$6.1bn) seen in the 1st half of this year.

AAA and AA AUD secondary market spreads finished the month 4-5bps tighter (to swap), though domestic 3yr and 5yr

bank funding costs remained relatively unchanged at 90bps and 120bps respectively. Following the wider moves seen in CDS (although slightly better) generic A and BBB spread finished the month 12bps and 17bps wider respectively.

So what can we expect out of the domestic market in September? At the moment we are on the wide of a 130bps-160bps index trading range and a tightening into the lower end of this range will need improved investor sentiment in the international markets.

## Inflation

It now appears that the combination of high interest rates, high petrol prices and falling asset prices has stifled household demand. The slowing in household demand is sufficient to warrant another cut in rates. Provided the run of data continues to show ongoing economic weakness, the RBA remains likely to cut by 25 bps at its October Board meeting.

## Oil

Over the past month the price of oil has been in a downtrend. Having peaked at a high of \$147.27 on 11 July, the oil price has since moved lower.

The weakening global outlook is cutting into the demand for oil and in NAB's opinion this fundamental has been instrumental in driving the oil price lower. But rising inventories in the US, speculators/investors dumping their futures positions and a stronger US dollar have all helped to drive the price lower.

It didn't take long for OPEC countries to agree to cut output to stabilise the falling price. Consequently, it is unlikely oil prices will dip below \$100 bbl for too long.

## Global economies and markets

The essentials:

- US GDP is estimated to have grown at an annualised rate of 3.3% in the second quarter, revised up from 1.9%. Early data, however, suggest growth is poised to fall back in the third quarter.
- Although the pace of growth is clearly slowing in China, the picture remains very mixed by industry and category of demand. The rate of growth in industrial output slipped from around 16% year on year in May and June to 14.7% year on year in July.
- Emerging markets have had large falls, with China down 13.6% in the month and 54% over the past year. Global markets in the whole were down which is consistent with a re-rating of expected corporate profit growth ahead, as well as ongoing financial de-leveraging.

## US

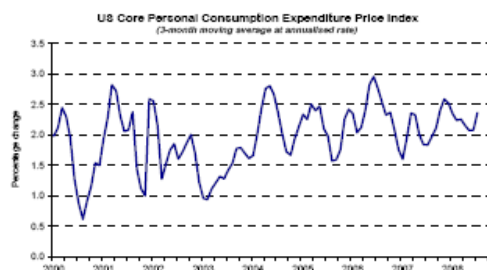
The upward revision to second quarter GDP has allowed the US to continue skirting recession, or at least a recession defined as two consecutive negative quarters of growth. GDP is estimated to have grown at an annualised rate of 3.3% in the quarter, revised up from 1.9%.

The renewed strengthening in growth was largely attributable to a strong rise in exports and, to a lesser extent, consumer spending growth. Indeed, the trade sector accounted for 3.1 points of GDP growth in the quarter. However, the contribution also partly reflected the impact of a 7.5% fall in imports, as stocks were run down (subtracting 1.4 points from growth) and other components of private final demand remained mixed. Residential investment contracted at a slightly slower rate in the quarter, and non-residential construction activity continued to expand briskly, but equipment investment again fell moderately.

However, early data suggest growth is poised to fall back in the third quarter (we estimate growth is likely to be broadly flat). With the tax rebates posted, and falls in employment and wages growth, real income and consumption both fell in July for the second consecutive month. Correspondingly, consumption will struggle to grow in the quarter. The recent sharp rise in mortgage borrowing rates also threatens to curtail earlier improvements in housing affordability and the slightly better tone in housing demand. More positively, a fourth consecutive rise in core durable goods orders in July points to at least a temporary upturn in equipment investment, and inventories are likely to add to growth in the quarter.

Declines in energy prices and a further weakening in growth together have given the Fed some comfort inflation risks may have peaked.

Chart: US Core Consumer price Inflation



## China

Although the pace of growth is clearly slowing in China, the picture remains very mixed by industry and category of demand. The rate of growth in industrial output slipped from around 16% year on year in May and June to 14.7% year on year in July. Some slowing was expected as the Government ordered the closure of some industrial plants around the capital to improve air quality for the Olympics.

But that does not seem to entirely explain the slowing in growth as the capital city region only accounts for a small part of the national economy. The slowdown was seen across both light and heavy industry whereas the plant closures were especially targeted at heavy industries like steel and aluminium. Heavy industry growth did slip from around 17% year on year to 15.7% year on year between June and July but light industry also slowed from 13.3% year on year to 12.2% year on year. Also some of the most recent business surveys point to continued slowing in the pace of growth in activity.

Urban fixed investment spending is still growing at over 25% year on year while retail sales values were up by around 23% year on year in both June and July. Retail inflation is running at around 7% year on year so the sales figures imply solid growth in retail spending of around 15% year on year. On the other hand, exports do seem to be slowing – which would be an expected outcome from the softening in key Chinese export markets and the stronger Yuan that has been hitting export margins.

## Japan

There is now real concern that the Japanese economy could be moving into recession. Output contracted by 0.6% in the June quarter and the weakness was broad-based. Consumer spending has been sluggish for years as household incomes have stagnated and it actually fell in June. Judging by the recent labour market surveys and the gloom evident in surveys of Japanese households, household spending should stay soft.

More worrying has been the decline in business investment and exports – previously the main drivers of growth in the economy.

Inflation has also accelerated as the economy has slowed. The rate of increase in the headline CPI was 2% year on year in June. Although inflation is running ahead of central bank expectations and getting toward the top end of the BoJ tolerance range, we are not expecting any lift in interest rates in the near term.

## Europe

The Eurozone economy stands on the brink of a 'technical' recession (two consecutive quarters of negative growth). Although partly due to the unwinding of earlier one-offs, GDP fell by 0.2% in the second quarter (the first fall since the launch of the euro in 1999). GDP fell in Germany (-0.5%), France (-0.3%) and Italy (-0.3%), with negligible growth also reported in Spain (0.1%) and the Netherlands (0.0). Despite an 8% fall in the euro against the USD since July and the fall in energy prices, the Economic Sentiment Indicator fell in August to the lowest level since early 2003. The decline is consistent with annual growth in Eurozone GDP slowing to below 1.0%.

In the second quarter, export growth continued to slow, dragging down business investment. Rather than due solely to the earlier rise of the euro, however, the export downturn appears partly due to stalling domestic demand in the US, the UK and other EU members. Much of the abrupt weakening in growth in the first half reflects declining household expenditure, with spreading weakness in housing sectors and surging food and energy costs offsetting falling unemployment and stronger wages growth.

The more recent fall in energy costs raises the prospect of a bounce in consumer spending growth. Moreover, the declines have contributed to a fall in inflation, and the first step towards an eventual easing in ECB policy. HICP inflation fell in both July and August, with the headline rate easing from 4.0% to 3.8%.

## Global share markets

Emerging markets have had large falls, with China down 13.6% in the month and 54% over the past year.

These sharemarket declines are consistent with a re-rating of expected corporate profit growth ahead, as well as ongoing financial de-leveraging. Sharemarkets will stop falling when investors are comfortable that the expected growth profile of profits ahead is realistic, that financial de-leveraging and asset deflation are nearing an end. With the most acute phase of macroeconomic weakness still likely ahead of us (we see US GDP growth at its weakest in Q4) we are probably not at this point yet.